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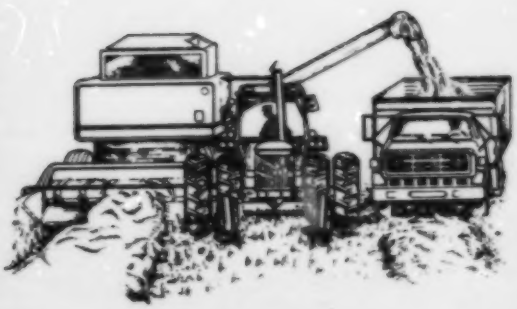

FARM INCORPORATION

Foreword

Favourable tax treatment and high net farm incomes encouraged many farmers to incorporate in the late 1970's and early 1980's. The 1981 census reported 1,892 corporate farms in Saskatchewan or 2.8% of all farms in the province. Of these, 93% or 1,768 were categorized as family farm corporations.

Recent tax changes have significantly affected the income tax benefits of incorporating. Fewer farmers will now find incorporation to be advantageous. However, farmers with high net incomes and the desire to expand the size of their farm may still benefit by incorporating, particularly if there are further benefits such as estate planning, limited liability or the need for a farm operating arrangement.

A corporation is a more structured and complex business organization than a proprietorship. Farmers should carefully and fully investigate all the advantages, disadvantages and alternative strategies before incorporating.

This bulletin indicates the advantages and disadvantages of farm corporations and provides information on the various means of establishing and operating a corporation. It is intended as a general guide for farmers and is not to be used as a substitute for qualified legal, accounting and tax advice.

Tax calculations are based on 1987 tax laws.

For further information or additional copies of this bulletin, contact your Agricultural Representative, Regional Farm Management Specialist, or the Farm Management Section, Saskatchewan Agriculture, Room 329, Walter Scott Building, Regina, Saskatchewan S4S 0B1.

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I. The Nature of a Corporation

A corporation is a separate legal entity that is created under Federal or Provincial statutes. It can have virtually all the rights, duties and responsibilities of an individual. For example, it can purchase, hold, and transfer property, obtain financing and enter into contracts. Most often, Saskatchewan farmers can accomplish their objectives by organization under the Saskatchewan Business Corporations Act. A corporation registered under the Saskatchewan Business Corporations Act may engage in activities outside Saskatchewan by registering in the jurisdiction in which it operates (e.g., Alberta). Alternatively, when a farm engages in business activities outside Saskatchewan, incorporation under the Canada Business Corporations Act might be considered.

Shareholders of a corporation are its owners. A share is a percentage interest in the equity of the business. For example, a share is a percentage ownership of all the land, buildings, machinery, livestock, feed, grain, supplies and cash after the liabilities of the corporation have been deducted.

1. Relationship of a Farmer to a Corporation

In a farm corporation, the relationship of the farmer to his business is much different than for a sole proprietorship. The following are some of the roles which may exist in a farm corporation:

a. Shareholder -- through the ownership of shares individuals own the corporation. Shareholders elect the directors who appoint officers of the corporation. Shareholders may receive dividends on the shares.

b. Officer -- an officer in a corporation directs the day to day business.

c. Directors -- are responsible for major policy directions and make major decisions such as the acquisition of assets or arrangements for credit.

d. Employee -- an individual may work for the corporation and receive a salary or wage.

e. Landlord -- an individual may lease some or all of his assets to the corporation and receive rental income.

f. Lender -- an individual may sell assets to the corporation and take back a note, mortgage or some other evidence of debt. The lender may receive interest and/or principal from the corporation until the debt is retired.

g. Borrower -- an individual might borrow money from the corporation for some personal purpose. The individual would be responsible for retiring the loan by paying principal and interest if applicable. In family farm corporations, some or all of the above roles may be played by one person.

II. Advantages of a Corporation

1. Taxation

One reason for incorporating a farm is to achieve income tax savings and deferrals. A rule of thumb is that each active person in the corporation should be receiving in excess of $50,000 net income before incorporating should be considered for tax purposes. The following are the main income tax advantages:

a. Small Business Tax Rate

The tax rate for small private Canadian Controlled Corporations is approximately 25 per cent on the first $200,000.00 of annual taxable income. Since 1985, there is no cumulative limit. Because personal marginal tax rates are much higher with only moderate levels of taxable income, it is possible to shelter earnings in a corporation and defer the payment of income tax to a later date. This is accomplished by not paying out all the corporate earnings as dividends, wages, salaries or interest but by retaining a portion of the earnings in the corporation. This is referred to as retained earnings.

The corporate tax rate is approximately 54% for taxable income in excess of $200,000.00 in any year. Since the corporate tax rate is a flat rate, there is no advantage in attempting to sell grain or livestock in one tax year as opposed to another. Tax management in relation to adjusting taxable income between years is simplified.

b. Dividends

Shareholders who receive dividends may deduct a dividend tax credit from the Basic Federal Tax. Since the Basic Federal Tax is used to determine provincial tax, the dividend tax credit reduces both federal and provincial tax.

The dividend tax credit reflects the corporate tax paid on its profits. In effect, it is a system which prevents double taxation on the same basic earnings.

c. Salary Paid to a Spouse

A corporation has always been able to pay a wage or salary to an individual's spouse providing that the spouse performed services for the business. Because of Canada's progressive tax system total personal income tax payable is less to the extent that a husband and wife can split income between

them rather than having all the income received by one spouse.

This advantage which was previously only available to a corporation has been available to sole proprietorship forms of business since January 1, 1980.

d. Rollover of Shares

Shares in a "family farm corporation" may be transferred from a parent to a child on a capital gain rollover thereby deferring tax liabilities on the shares to the succeeding generations.

This as well as other aspects of taxation are discussed in more detail in later sections of this publication.

2. Separation of Ownership, Control and Division of Profits

Normally, a person who owns an asset also controls it in terms of its management and is entitled to receive all the profits from it. There can be advantages for tax planning, estate planning and in transferring property to separate these rights. This can be accomplished in the organization and the structuring of share capital in a corporation.

For example, one class of shares might have voting rights (control), while another class of shares might be entitled to dividends (a distribution of corporate profits). Certain classes of shares might be entitled to share in the growth of the corporation while others might not. Therefore, it would be possible to transfer ownership of a corporation and still retain control.

3. Flexibility in the Distribution of Income

A corporation may pay out salaries, management fees, rentals, dividends, interest or principal. The type of distribution and the amount can be selected which results in the greatest advantage to the corporation as well as the individual receiving the money.

4. Estate Planning and Transfers

Corporate shares are easier and less costly to transfer to beneficiaries than is real and personal property such as cattle, grain, etc. It is easier to divide shares which are relatively low in value compared to say a quarter section of land with a much larger value.

The estate of an individual can be frozen in a corporation. This can be accomplished by transferring assets to a corporation and taking back notes or non-growth shares which will not increase in value. The growth shares can be issued to other individuals who will realize all future growth in the equity of the corporation.

5. Limited Liability

The liability of shareholders is limited to the amount paid for the shares. This has an advantage in that an individual's assets owned outside the corporation are protected if the corporation becomes insolvent. The advantage of limited liability is lost if creditors require the personal guarantee of shareholders before credit is extended. It is possible, however, for a shareholder to limit his liability with a creditor to a certain amount (e.g., $20,000).

A corporation can offer protection in the case of third party liability since only the assets of a corporation can be used to settle a liability claim and not those of the shareholders. However, liability insurance can be purchased to overcome third party liability for corporations, partnerships, and sole proprietorships.

6. Continuous Existence

A corporation has perpetual existence as long as the shareholders wish it to and the requirements of the Saskatchewan Business Corporations Act are met.

When one of the shareholders dies, the corporation carries on rather than terminate as would be the case when the owner of a sole proprietorship farm dies. However, if the farm corporation is controlled by one person and that person dies, it may be necessary to dissolve the corporation, if no one is prepared to manage the organization.

Grain, feed, supplies and livestock on hand at the date of death of a farmer are called Rights and Things. The value of the Rights and Things must be brought into income either on the farmer's estate income tax return or in the return of the beneficiaries. This tax problem does not occur when the shareholder of a corporation dies, since the corporation which has perpetual existence owns these assets.

7. Improved Farm Management and Accounting

The more structured organization of a corporation often lends itself to better management. A higher standard of accounting is required which provides a better basis for decision making and control of the business.

8. Pooling Resources and Management Skills

A corporation is a type of business arrangement that allows two or more individuals to pool their resources. This may result in cost savings and improved output through better utilization of labor and management expertise and capital available (land, buildings, equipment and operating funds). Increased scale of operation may improve market strategies in buying or selling.

9. Availability of Credit

To the extent that the farm operates on a more business-like basis with better accounting and a larger capital base, it may be easier to arrange for credit.

10. Responsibilities of the Business to the Owner

A shareholder can sue a corporation for negligence.

11. Keeping the Farm as One Unit

A corporation permits an individual to plan his estate in a manner which allows the farm to remain as one entity, yet permits the division of the estate's value among several beneficiaries.

III. Disadvantages of a Corporation

1. Extra Costs

There are legal and accounting fees to establish a farm corporation as well as annual accounting and legal fees once the corporation is operating.

The Corporations Branch charges a fee for filing the annual return each year plus a fee when the corporation is established.

Additional costs will arise for drawing sales agreements, land transfers, buy-sell agreements, mortgages, issuing shares and the establishment of profit sharing plans.

2. Extra Administration

There are more rules, regulations and formal documentation required for a corporation than for a sole proprietorship. Minutes of meetings must be maintained in an appropriate minute book, an annual meeting is required, an annual return must be filed with the corporations branch, and income tax and accounting requirements are more involved.

More consultation with lawyers, accountants and management advisors will occur because of the greater complexity of the organization.

3. Income Tax

a. Principal Residence

A corporation cannot own a principal residence as defined in the Income Tax Act. Therefore, when property which includes a house is sold there can never be a capital gain exemption for the house.

Often when farm corporations are established, the house is not transferred to the corporation. The farmer retains title to his house and providing the other conditions relating to a principal residence ar met, the capital gain on the sale of the house would be exempt from tax.

b. Taxable Benefits

A shareholder or employee of a corporation is subject to the payment of income tax on certain benefits received. For example, if an individual has personal use of a company car or house, then a value is attached to this benefit which becomes taxable income to the individual. Low interest rate loans are also a taxable benefit.

If an individual pays a reasonable amount to the corporation for these benefits, then taxable benefits would not occur.

c. No Tax Averaging Provisions

A corporation is not permitted to use the Five Year Block Average or forward averaging. Since a corporation always has the same rate of tax, averaging provides no benefit except in situations where the level of income is such that the small business rate of 25% no longer applies. The tax rate for profits in excess of $200,000 per year is approximately 54%.

d. Business Losses Cannot Be Carried Out of the Corporation to an Individual Shareholder

In situations where the corporation experiences business losses, such losses cannot be allocated to shareholders to improve their income tax situation. When business losses occur, the combined tax situation of the corporation and shareholders will be worse than if the business had operated as a sole proprietorship.

Corporation losses may be carried forward within the organization.

e. Active Business Income

Only income defined as active business income realized by a corporation qualifies for the preferen-

tial small business tax rate of 25%. All other corporate income would be taxed at a rate of 54%.

f. High Cost of Dissolving a Corporation

When a corporation is dissolved there are no provisions for averaging or deferring the income tax that may occur when assets are sold or transferred by the corporation. When assets are transferred to shareholders the value used must be the fair market value of the assets. The liability for all capital gain or other deferred income is realized when the corporation is dissolved or any assets are sold.

Legal and accounting costs will also be incurred when a corporation is dissolved.

It is possible to undertake a corporate reorganization whereby the assets of an existing corporation are transferred to two or more other corporations without incurring capital gain on the transfer. This is known as a butterfly split whereby two or more shareholders in a corporation could split their business into separate entities. Expert accounting advice must be obtained in such circumstances.

With the high cost of dissolution, a corporation should only be formed if it is intended to have a long life.

g. Penalties for Personal Use of Corporate Funds

If personal or living costs are paid for by the corporation, it could result in double taxation and penalties to the shareholders and the company. All corporate funds used for such purposes should be accounted for and allocated as salary, dividends or payments on shareholders' loans.

h. Basic Herds

A Basic Herd which was established by a farmer prior to 1972 cannot be transferred to a corporation.

i. Investment Tax Credit

The Investment Tax Credit on assets purchased by a corporation is available for use only by the corporation. Investment Tax Credits carried forward by a corporation cannot be used by a shareholder to reduce his personal Federal Income Tax Payable.

j. Capital Gains Exemption

The $500,000 Capital Gains Exemption can not be used by a corporation to offset capital gains realized on the disposition of assets. The exemption is available only to individual taxpayers. Consequently, a shareholder who disposes of shares that result in capital gain could apply the Capital Gains Exemption to the gain on the shares.

k. Minimum Tax

Minimum tax (beginning in 1986) applies to individuals including shareholders, but not to corporations. Shareholders in receipt of large amounts of dividends or capital gains may be subject to minimum tax.

Minimum tax is payable if it exceeds the tax calculated in the normal manner. Minimum tax may be payable when certain types of income are received such as dividends or capital gain or deductions are claimed for investment tax credit, share-purchase tax credit, scientific research tax credit, losses from MURBs, film and video tapes, resource expenses, RRSP or pension plan contributions, or transfer of deductions from a spouse.

For dividends, it is unlikely that minimum tax will apply for taxable dividends of less than $60,000 in one year.

4. Minority Shareholders

Shareholders who have a small number of shares in relation to other shareholders have little power to change the operation of a corporation. Non-farm children are often placed in a minority shareholder position relative to the farming children in a corporation. Their rights to sell the shares or force a satisfactory rate of return on the shares are often restricted. However, the Business Corporations Act does provide certain rights to minority shareholders. In some situations, minority shareholders can force the corporation to purchase their shares.

The bylaws of a corporation can provide some degree of protection for minority shareholders. This is discussed in greater detail later in this publication.

5. Loss of Freedom and Individual Identity

A farm corporation is a more complex business organization. It requires time and knowledge to fully understand and master its operation. Many farmers are unable to cope with a situation like this and become disenchanted with a corporate structure.

Many farmers take great pride in owning land, buildings, machinery, livestock and grain in their own name. When a corporation owns these assets the pride of individual ownership may be reduced.

6. Mineral Acreage Tax

In Saskatchewan, any individual with mineral rights on 3,200 acres or less is exempt from the Mineral Acreage Tax. Farm corporations are not exempt but are charged a tax of $0.50 per acre. This tax can be avoided by having the individual transfer only the land to a corporation and retain title to the minerals in his own name.

7. Ability to Work Together

In corporations involving more than one shareholder, the parties must be able to get along. A certain amount of "give and take" is essential. Individuals who have difficulty getting along beforehand may find their differences intensified in a corporation.

IV. Steps in Incorporating

Farms which incorporate should do so after carefully investigating the pros and cons of incorporating and determining which strategies will be best to adopt. Typically there are three steps involved in incorporating a farm.
These are:

- Investigating and Development
- Formation of a Corporation
- Financing a Corporation

1. Investigating and Development

The structure, operation and alternative organizations of a corporation are often difficult to understand. Therefore, a great deal of investigative time is involved. It may take several months or even years from the time a farmer first considers incorporation to its formation.

Accounting and legal advice should be obtained soon after the idea of incorporating occurs. Normally, it is better to hire a lawyer and accountant to set up the corporation. However, The Saskatchewan Business Corporations Act has made incorporation quite simple and straight forward. An individual who does some research and reading on his own should be able to complete the incorporation procedure himself.

Factors to consider when investigating the merits of a corporation include the following:

- The objectives for incorporating your farm
- Management and control
- Share structure and allocation of shares to shareholders
- Alternative methods of organizing
- Financing
- Transfer of assets to the corporation

2. Formation of a Corporation

Most farms incorporate under the Saskatchewan Business Corporations Act. This provincial statute became effective in 1977 when it replaced the old "Companies Act".

a. Types of corporations

Two types of corporations are distinguished in the Act. These are:
i. Non Distributing (Private)
ii. Distributing (Public)

Distributing corporations offer their shares to the public. Distributing corporations must disclose their financial position and comply with the many regulations of the Saskatchewan Securities Commission.

Non distributing corporations (private) are not required to meet the same requirements of a distributing corporation. Therefore, in the majority of cases, farms operate as non distributing corporations. While a corporation becomes a distributing corporation by its actions, that is, distributing shares to the public, a corporation may in the Articles of Incorporation include the following to indicate that it is a non distributing corporation:

- restriction on the transfer of shares
- prohibition on offering shares to the public
- restriction on the number of shareholders

b. Number of Shareholders

A corporation can be formed with one shareholder. There is no upper limit to the number of shareholders permitted in a non distributing corporation.

In a one shareholder company, that person will perform the functions of president, secretary, sole director and sole shareholder.

c. Name of a Corporation

A corporation's name must be approved by the Corporations Branch, Saskatchewan Government. A name should be selected that is distinctive and represents the nature of the business if possible. Names including "Canadian", "Saskatchewan", "Co-operative", "Pool" or words of a similar nature are not permitted.

The corporation's name must end with one of the following: Limited, Limitee, Incorporated, Incorporee, Corporation, or the abbreviations: Ltd., Ltee., Inc. or Corp.

The Corporations Branch charges a fee for reserving a name. Three selections for a name should be sent in with the application in case one or two are rejected.

d. Filing Documents with the Corporations Branch

A fee is charged by the Corporations Branch to process the incorporating documents. Duplicate copies of the Articles of Incorporation, Notice of Registered Office and Notice of Directors must accompany the fee.

One stamped copy of each of the above is returned. These documents should be filed in the corporation's minute book. A Certificate of Incorporation is also issued by the Corporations Branch at this time.

i. Articles of Incorporation

The articles of Incorporation are really the constitution of the corporation. The following information should be contained in the Articles of Incorporation:

1. Full Name of Corporation

2. Municipality in which registered office is located.

3. Share structure. This is the type of shares (e.g. common or preferred) and the maximum number of shares of each class that may be issued if a limitation in the number is intended and if no limit is intended then it should be stated that unlimited is the number.

Any special rights, privileges, restriction or conditions that apply to shares must be stated. The shares may be issued for any consideration desired, however, no par value may be set on the shares. Not all the shares need to be issued. Those shares unissued remain with the corporation and can be issued at a later date.

If there is a limited authorized number of shares specified, the limit can be changed later by filing Articles to amend Articles of Incorporation and by passing a special resolution.

4. Restrictions on Share Transfers. The incorporators may wish to place other restrictions on the shares. Possible restrictions include the following:

- Shares may not be transferred to anyone other than an existing shareholder without the approval of the holders of a certain percentage of the shares.

- Shares may not be transferred unless approved in a resolution by a majority of the board of directors.

- Shares may not be transferred without the approval of the holders of a majority of the shares and a majority of the board of directors.

Restrictions on the transfer of shares helps to protect existing shareholders.

5. Number of Directors. The minimum and maximum number or a fixed number of directors must be indicated.

6. Restrictions on the Business Activities of the Corporation. In most cases it is best not to restrict the activities of the corporation in order to permit the greatest flexibility. This is particularly true for small non distributing corporations with a few shareholders.

Occasionally restrictions are placed on the business activities of a corporation in order to protect investors.

7. Other Provisions. A corporation may use this section to indicate that it is non distributing. This can be done with the following clauses:

- prohibit the offering of shares to the public

- restrict share transfers

8. Incorporators. The name, address and signatures of the incorporators must be provided.

ii. Notice of Registered Office

The registered office must be in Saskatchewan. The full address of the office must be filed. The registers, minute book and perhaps the accounting records must be available for inspection at this location during business hours.

If the registered office is changed, notice must be given to the Corporations Branch within 15 days.

iii. Notice of Directors

Each director's name in full, his address, occupation and citizenship must be stated.

e. Electing Directors

The following conditions apply to directors:

i. the majority of the directors must be Canadian citizens

ii. at least one director must be a resident of Saskatchewan

iii. be at least age 18

iv. be of sound mind

v. be an individual (not a corporation)

vi. not be bankrupt

Directors are elected at the first meeting of the shareholders after the incorporation. A director may not have a term greater than three years, but a director may be re-elected for a further term.

Shareholders may remove a director from office by passing a resolution at a special meeting of shareholders.

The Saskatchewan Business Corporations Act provides that directors have certain duties and responsibilities. These include the responsibility of directing the management of the company, and set the rules and regulations governing meetings, directors' conflict of interest and the liability of directors for mismanagement of company affairs. Shareholders may take action against directors who have mismanaged the affairs of the corporation.

f. Shareholders

Shareholders are the owners of the corporation. At the first meeting of the shareholders after incorporation, the shareholders elect directors to manage the corporation. Directors appoint officers (president, secretary, treasurer) who operate the company.

The line of authority is shareholders who delegate authority to directors, who in turn delegate authority to officers. In small, closely held corporations the shareholders, directors and officers are often the same people. Different people have these responsibilities in larger corporations.

Since the shareholders are the owners of the corporation and assign certain responsibilities to directors, The Business Corporations Act grants shareholders the right to take action against directors in some circumstances. These rights include the following:

i. The right to have the corporation redeem the shareholders' shares at fair market value if the corporation makes what is called a fundamental change to its articles, transfers to another jurisdiction, amalgamates with another corporation or sells, leases or exchanges all or substantially all of its property.

ii. Shareholders may apply to the courts to have the company wound up if the directors improperly mange the corporations affairs.

iii. Shareholders on behalf of the corporation can take action against directors to prevent the corporation from doing something harmful to itself.

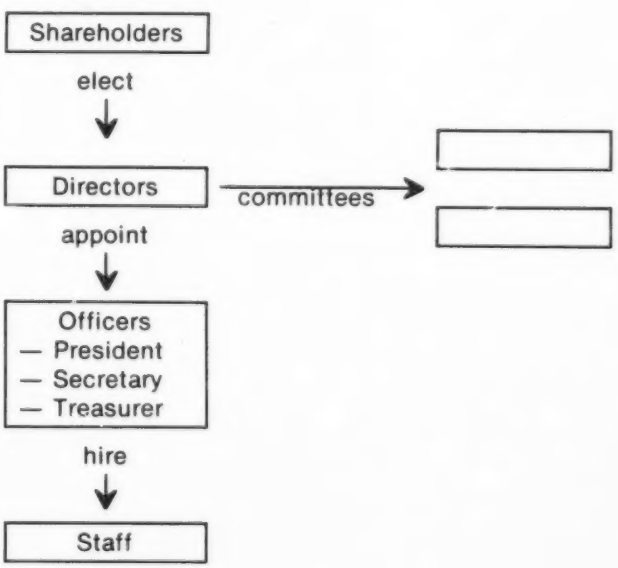
iv. When the business is carried on in a way which disregards the interest of shareholders, directors, officers or creditors of the company, the shareholders can request a court to order the action stopped. It can also ask that directors be changed or that contracts be cancelled. Compensation may be payable to the person suffering the loss.

v. Shareholders can call a meeting of directors if the directors fail to do so.

vi. A shareholder can ask the court to investigate a corporation if it is suspected that the corporation is defrauding any person, if it disregards the interests of a security holding, or if it operates for unlawful purposes.

g. Line of Authority

The following figure depicts the line of authority in a corporation.



h. Bylaws of the Corporation

The bylaws become the rules and regulations that govern the operation of a corporation. Directors may pass a set of bylaws.

If the corporation does not make its own bylaws, then the provisions of The Business Corporations

Act of Saskatchewan in effect become the bylaws of the Corporation. For a small, private corporation with only two or three shareholders, this may be satisfactory. However, the provisions of the Act should be reviewed to determine if some aspects are not adequate or are inconsistent with the intentions of the incorporators. Bylaws cannot be adopted that are not permitted by The Business Corporations Act.

Amendments or additions to the bylaws can be made at any time and should be filed in the minute book.

The following points should be considered in the corporation's bylaws:

1. Location of registered office
2. Provisions for a corporate seal
3. Fiscal year
4. Signing authorities for contracts and other documents.
5. Provision for banking arrangements
6. Provision for storing securities and shares of the corporation.
7. Authority to dispose of securities
8. Power of directors to borrow money
9. The number of directors, the method of their election and their term can be specified in the bylaws as well as their qualifications and conditions necessary to be a director.
10. Powers of the directors can be stated and rules for the conduct of meetings.
11. The directors may set up committees with specific functions to perform.
12. The Board of Directors appoints officers of the corporation. The officers include a president, secretary, vice-president, general manager, treasurer and others that are deemed advisable.

Vice-Presidents have the powers of the president in his absence. The secretary takes minutes at the meetings of the board of directors, shareholders and committees of the board. The secretary properly enters the minutes in the corporation records and gives notice of meetings.

The treasurer looks after all corporate funds and securities and maintains proper accounting records.

The general manager is appointed by the board of directors. The general manager can be given the authority to manage and direct the business and affairs of the corporation and to supervise employees.

13. An annual shareholders' meeting is called by the board of directors, or failing it, the president. At the annual shareholders' meeting, reports and statements of corporate affairs are examined, directors are elected, auditors are appointed and other business that may be brought before the meeting is dealt with.

14. The board of directors govern the issue of shares of the corporation.

Shares may not be issued until fully paid for.

i. Other Considerations

After the corporation is established, a bank account should be established and signing officers appointed. It may be desirable to limit the amount of a cheque that may be issued without the agreement of all signing authorities.

In addition, the ownership of insurance policies, land titles, mortgages and vehicle registrations must be changed.

A good accounting system should be established and an accountant hired.

3. Financing a Corporation

The source of capital for a corporation can be obtained from three sources.
These are:

- shares
- internal financing
- external financing

Shareholders may purchase shares thereby attaining an equity (ownership) position in the corporation. The amount paid for the shares is capital available to finance and operate the corporation. Internal financing includes loans made to the corporation by shareholders (shareholders' loans), use of corporate profit to finance the corporation (retained earnings), and the transfer of assets to the corporation by shareholders or others. Normally the corporation will show a debt on its books by way of a shareholder's loan, promissory note or mortgage for the value of assets transferred to it by any person.

External financing occurs when the corporation borrows from commercial lenders such as banks or mortgage companies.

a. Shares

Shares indicate ownership in the corporation. Depending on the rights attached to shares, the shares may command a portion of the equity in the corporation, a portion of the corporation's profit (a dividend) and the right to a say in how the corporate affairs are handled (voting rights). The Business Corporations Act of Saskatchewan refers to classes of shares (rather than the use of the terms common shares and preferred shares) and different rights that may be attached to different classes. Examples are as follows:

i. Types of Shares

1. Preferred Shares – preferred shares have a right to dividend payments in priority to common shares. If the company is wound up, the preferred shares have a higher claim to the corporation's capital than would common shares. Preferred shares may be fixed in value and do not change with the growth of the corporation. To some extent, they are much the same as shareholders' loans.

2. Common Shares – are entitled to the residual profits of the corporation as a dividend after all other demands have been met. If the corporation is wound up, the common shares are entitled to the remainder of the capital after all other capital demands have been met. All the corporation's growth will accrue to the holders of the common shares. Therefore, common shares may increase or decrease in value depending on how well the corporation does financially.

3. Classes of shares – shares can be differentiated by classes to allow slightly different rights. For example, a corporation may have Class A common shares and Class B common shares to allow different rights to different shareholders.

ii. Rights Attached to Shares

1. Voting Rights – voting right may be assigned to any type of share whether it be common or preferred shares although most frequently common shares are assigned the voting rights.

Each voting share has one vote. One half of the total shares plus one share will carry a decision. Voting shares indicate control. If one individual has more than one half of the voting shares, then he has control. Minority shareholders will have little say in the management of the corporation except in situations where under The Business Corporations Act the minority shareholders may exercise their rights in certain circumstances.

2. Redeemable – this gives the shareholder the right to sell his shares back to the corporation at his request.

3. Retractable (redeemable at the discretion of the corporation) – this gives the corporation the right to buy back shares from shareholders.

4. Cumulative – if a fixed dividend is payable each year, but no dividend can be declared that year because of low earnings, the dividend must still be paid and will accumulate until the corporation is able to pay. Non-cumulative shares mean that dividends do not accumulate if in one year the corporation is unable to pay the dividend.

iii. Selecting a Share Structure

In selecting a share structure the shareholders' objectives must be considered. These objectives may include some of the following:

1. Simple Structure – one class of shares such as voting common shares.

2. Freeze an Estate – two classes of shares: Preferred voting shares, issued to the person whose estate is to be frozen in return for assets transferred to the corporation. These shares will not change in value.

Common shares are issued to the children and the spouse. Common shares will receive the future growth of the corporation.

3. Separation of ownership, control and division of profit – several shares may be issued. For example:

- Preferred non-voting shares may be issued to the individuals transferring assets to the corporation.

- Class A common voting shares may be issued to those shareholders who are given control and rights to dividends.

- Class B common non-voting shares are issued to those shareholders who are given rights to dividends, but no control as far as voting is concerned.

4. Split Income between Husband and Wife – The following share structure may be selected:

- Preferred non-voting shares are issued to the person transferring assets.

- Common voting shares are issued to the husband and wife in the same proportion as they decide to divide dividend income. Recent tax rulings would suggest that the husband must not be free to direct the flow of dividend income to either the husband or the wife through a complex share structure. This means that the husband and wife must each have the same type of shares otherwise dividends paid to a spouse may be deemed taxable income in the husband's hands.

When shares are issued to a wife, the following points should be kept in mind:

- the shares should be issued by the corporation to the wife.

- the wife should pay for the shares from her own source of capital. If the capital to pay for the shares originated with the husband, then for taxation purposes the shares are deemed to be the

husband's. In this case, capital gain on the shares or dividends would be taxed as the husband's income. If the wife does not have her own funds, and since shares are issued at a nominal value, she could easily borrow the money on a short term basis from a bank.

Under the attribution rules of the Income Tax Act, shares that are given by a parent to a minor child result in capital gain and dividends being taxable in the hands of the parent up to the time the child turns 18 years of age. After that time capital gain and dividends would be taxable in the hands of the child.

Normally, it is not advisable to transfer or give shares to a minor child since they are unable to deal with the shares. In addition by the time the child reaches maturity the capital represented by the shares could be quite large.

b. Transfer of Assets to a Corporation

Existing farms may have assets comprised of land, buildings, improvements, equipment, livestock, grain, feed and supply inventories, personal property or cash. In addition, there may be liabilities or other charges against the assets.

At the time of incorporation, the shareholders decide on what assets and liabilities will be taken over by the corporation and how the transfer of assets will be financed. The main considerations in transferring assets to the corporation is the income tax effect on the individual and corporation and the degree of flexibility desired in handling assets.

The initial step in deciding what assets to transfer and at what value is to determine the relevant values. List each asset and establish the current fair market value and the cost at the date of purchase. If the property was owned on December 31, 1971 the Valuation Day value is required. The undepreciated capital cost is also required for depreciable property.

Individuals should attempt to justify the values used in the event of a dispute with Revenue Canada. In valuing real estate, data on comparable sales is ideal. Alternatively, an appraiser could be hired to establish values.

Section 85 of the Income Tax Act permits a taxpayer to transfer assets to a corporation on a capital gain rollover, thereby deferring income tax to a later time. The rollover is permitted only in certain circumstances and if specific procedures are followed.

The various classes of assets that may be transferred to a corporation are classified as land, principal residence, Part XI depreciable assets, Part XVII depreciable assets, inventories (marketable grain, livestock and farm supplies) and basic herds.

The various alternatives for handling these assets are discussed below:

i. Alternatives for land

1. Rollover of Land to the Corporation – For capital gains purposes, a transfer value can be elected anywhere between the fair market value of land at the time of transfer and the consideration received for the land other than shares. Consideration may be cash, shareholder's loan, an agreement for sale or some other debt instrument.

When this provision is used, it is common to have the land transferor receive consideration equal to the adjusted cost base of the land. Then the value elected is equal to the consideration which is also the adjusted cost base. No capital gains are realized by the transferor. At the same time preferred shares equal in value to the difference between the fair market value of land and the consideration received are issued to the land transferor. It is suggested that the preferred shares be retractable and redeemable. This means that the shares may be redeemed at the option of either the corporation or the shareholder. These features mean that the preferred shares are maintained at their value at the time of issue.

The following example illustrates the above procedure:

Land - Fair market value	$100,000
- Adjusted cost base	20,000
- Consideration received on transfer to corporation	20,000
- Elected transfer value	20,000*

* The elected transfer value may not exceed the fair market value or be less than the consideration received.

Capital Gain to transferor =	
Elected transfer value	$20,000
Adjusted cost base	20,000
Capital gain	Nil

80,000 preferred shares (redeemable and retractable) are issued at $1.00 per share. This amount is equal to the difference between the fair market value of the land and the consideration received ($100,000 – $20,000 = $80,000).

For taxation purposes, the transferor and the corporation must file form T2057 with Revenue Canada, in which the consideration for the land is an elected amount ($20,000 in the above example). The adjusted cost base for the corporation

becomes the elected amount. The subsequent sale of the land at market value would result in a capital gain to the corporation.

For accounting purposes, the land will appear on the corporation's balance sheet with a value equal to the sum of the consideration paid plus the value of the redeemable retractable preferred shares issued. In the above example, the land would have a value of $100,000 on the balance sheet.

The land transferor who receives the redeemable retractable preferred shares is, for taxation purposes, deemed to have acquired them with an adjusted cost base of zero. The subsequent sale of these shares at market value would result in a capital gain ($80,000 in the above example). The Capital Gains Exemption may be used to offset the capital gain. However, minimum tax may apply.

Potentially, the land in the corporation and the preferred shares of the shareholder could be subject to capital gain, thereby generating a double tax liability for the same basic gain.

However, since the preferred shares, in most cases, can be rolled over to family members this problem is not likely to occur (see the taxation section).

Implications of this option

- Money received for the consideration is free of tax to the individual.

- Capital gain is deferred.

- Land "value" is frozen. Future increase in value can be transferred to other family members depending on the share structure.

- A capital gain rollover applies to share transfers to future generations.

- Capital gain tax liability when the shares are sold at market value. However, the Capital Gains Exemption may offset this.

- Capital gain tax liability to the corporation if it sells land.

- Large tax liability if the corporation is dissolved.

- Cannot transfer the land back to the shareholders without a tax liability to the corporation.

- Loss of direct control of the land.

2. Land is Sold to the Corporation – Land could be transferred to the corporation by selling it at fair market value. This results in a capital gain to the land transferor equal to the difference between the selling price (fair market value) and the adjusted cost base. The capital gain for the transferor could be offset using the $500,000 Capital Gain Exemption. The corporation then has a higher cost base on the land and will result in less capital gain if the corporation ever sells land or transfers it back to the shareholders. However, minimum tax may apply. If the land transferor sells the land on an agreement for sale or takes back a mortgage on the land, up to a five year capital gain reserve can be created for the principal unpaid. This will allow minimum tax averaging over a five year period. Another alternative is for the farmer to apply a five year Block Average in the year of sale to eliminate the need to calculate minimum tax. In order to have the right to claim the reserve, there must be a stated repayment schedule. The principal unpaid must not be payable on demand. Interest need not be charged.

Implications of this option

- A portion of the money received is free of tax to the individual. The total amount of consideration is greater with this option than with a Section 85 rollover, therefore a much larger amount of money may be withdrawn from the corporation. However, there may be tax on the taxable capital gain if the total capital gain exceeds the $500,000 Capital Gain Exemption limit.

- The land "value" is frozen as in a Section 85 rollover.

- Problems in dealing with preferred shares issued on transfer of land are avoided.

- The tax liability of the corporation for capital gain is reduced if the land is sold shortly after incorporation or the corporation is dissolved and assets are transferred back to the shareholders.

- A capital gain tax rollover applies to share transfers to future generations.

- The land transferor will incur capital gain on the transfer of land to the corporation but may be eligible to use the $500,000 Capital Gains Exemption.

- Minimum tax may apply.

- Loss of direct control of the land.

3. Land is Leased to the Corporation – Shareholders would lease land to the corporation and receive a cash rent or crop share rent. Individuals often wish to retain ownership of land rather than transfer it to a corporation. Since 1984, farm land leased by a taxpayer to his family farm corporation or to his spouses or child's family farm corporation will qualify for a rollover to a child.

There is uncertainty about the amount of rent that must be paid by the corporation to the shareholder-landowner. One opinion is that the rent must be a fair market value rent while others state that a nominal rent is satisfactory. Normally it is preferable to have the corporation receive as much income as possible and either retain the earnings or pay the shareholders by way of dividends. If the landowner receives a fair market rent, then much of the taxation benefits of incorporation is lost.

Implications of this option

- Land ownership is retained by the individual. There is more flexibility in dealing with land in the future.

- If the corporation were dissolved, the legal and tax costs of dissolution would be relatively low.

- Land leased to a family farm corporation will qualify for a rollover to a child.

- By paying rent, part of the income tax advantage of incorporation is lost.

- Land "value" is not frozen.

- More complex procedure when borrowing money.

- More accounting and administration

4. Land Continued to be Owned and Operated by the Shareholder – The shareholder-landowner would retain the title to some or all of the land in his name. Some or all of the machinery would be transferred to the corporation.

The land owned individually would be farmed separately from the corporation with individually owned machinery, or corporation machinery would be hired on a custom basis. This technique is much the same as leasing land to the corporation. As with leasing a large portion of the income generated from the land would bypass the corporation and go directly to the individual shareholder with a resulting reduction of the income tax advantage of incorporation.

Implications of this option

- The capital gain rollover on the transfer of farmland from a parent to a child is maintained.

- Land ownership is retained by the individual. There is more flexibility in dealing with the land in the future.

- If the corporation were dissolved, the legal and tax costs of dissolution would be relatively low.

- The income tax provisions for a principal residence are maintained.

- The individual has the status of a farmer and can use the Investment Tax Credit against federal income tax payable on personal income.

- A major portion of the income from the land bypasses the corporation and goes directly to the shareholder. A significant tax advantage of incorporating is lost.

- Land value is not frozen.

- More complex procedure when borrowing money.

- More accounting and administration.

5. The Corporation and Individual Operate under a Farm Operating Agreement – Initially, some assets such as machinery, land, buildings or livestock may be transferred to the corporation while the individual retains ownership of most of the asset base. The individual and corporation operate the combined farm unit under a farm operating agreement whereby the income and expenses are shared according to the relative contributions of the two parties.

The acquisition of future assets can be made by the individual or the corporation, whichever is more advantageous.

Implications of this option

- Since the individual retains status as a farmer, the capital gain rollover of land, buildings and machinery to a child may still occur.

- There is more flexibility in dealing with land in the future.

- The operation is flexible to permit change to most advantageously conform to changing income tax and other government regulations.

- Capital asset acquisitions can be made by either the individual or the corporation.

- Low start up costs.

- There is much more accounting and administration.

- Since not all the income is initially received by the corporation, part of the income tax advantage of incorporation is lost.

- More complex procedure when money is borrowed.

In summary, it appears that the best option is to transfer land to the corporation at fair market value and have the transferor offset the gain with the $500,000 Capital Gains Exemption. Planning around the minimum tax rules would be necessary. The second best alternative would be

to transfer the land to the corporation using the Section 85 rollover.

Land may be leased or custom work hired from the corporation when the shareholders wish to experiment with the corporate structure before making a full commitment. Later if a long range commitment is evident the land could be transferred to the corporation.

When transferring title to land from an individual to a corporation substantial land titles and legal fees occur. A method of deferring payment of these fees is to sell the land to the corporation on an agreement for sale whereby title to the land does not pass to the corporation until the last dollar is paid. As long as one dollar is unpaid, the transfer fees could be postponed indefinitely.

ii. Principal Residence

Only individual taxpayers may have a principal residence. Corporations may not. At the time of incorporation the individual may transfer the personal portion of his principal residence (normally 3/4; the other is 1/4 is normally a business portion) tax free, to the corporation. Alternatively the principal residence exemption may be used. However, the house owned by the corporation would be subject to capital gain if the house were sold at an increased value in the future. If the house owned by the corporation is personally used by one of the shareholders, the shareholder must pay a reasonable rent or be deemed to receive a taxable benefit.

Normally, it is best for the owner to continue to own the principal residence, since it will be exempt from capital gain when transferred. Often, however, the principal residence may be located on a piece of land which is transferred to the corporation. If the land is to be transferred to the corporation, the following two alternatives exist:

1. A long term leasehold agreement can be prepared which gives the owner of the house the right of access and the use of the house and a small area around it.

2. The house owner could apply to the rural municipality to subdivide a small acreage on which the house is situated on the quarter section.

iii. Alternatives for Part XI Depreciable Assets (Diminishing Balance)

Part XI depreciable assets most often include machinery and buildings purchased after December 31, 1971. The options for Part XI depreciable assets are as follows:

1. Sale to the Corporation – the effect on the tax position is the same as if the assets were sold to a third party at fair market value. Recaptured capital cost allowance equal to the difference between the fair market value (if not greater than original cost) and the undepreciated capital cost will occur. Capital gain equal to the difference between the fair market value and adjusted cost base will also occur.

There is no tax averaging provision available to the individual to handle recaptured capital cost allowance.

Implications of this option

- The corporation has a higher capital cost allowance base.

- High immediate tax cost because of recaptured capital cost allowance and possible capital gain to the individual.

- Lower tax cost to the corporation if it is dissolved.

2. Rollover to the Corporation – with this election, a transfer value is selected that is anywhere between the fair market value of the assets and the consideration other than shares received for the assets. The most common situation is where consideration is received for an amount equal to the undepreciated capital cost of the assets, therefore, recaptured capital cost allowance does not occur. At the same time preferred shares equal in value to the difference between the fair market value of the asset and the consideration received (undepreciated capital cost) are issued to the transferor.

The corporation acquires the assets with the same undepreciated capital cost and original costs as the transferor.

Implications of this option

- There is no immediate tax cost to either the individual or the corporation.

- When the assets are subsequently sold, the recaptured capital cost allowance will be taxed in the corporation rather than in the individual's hands. This should be at a lower tax rate.

- A capital gain rollover is permitted on the shares received when the assets are transferred to the corporation.

- Larger tax liability if the corporation is dissolved.

3. Shareholder Continues to Own the Assets – Some or all of the machinery or buildings may be retained by the shareholders rather than transferring

them to the corporation. This technique may be used when a great deal of flexibility is desired and the shareholders believe that the corporation may last only a short period of time.

With this technique a much larger amount of income must be received directly by the shareholders. Since the tax advantages of incorporation are greatest when the income is routed through the corporation and then retained by the corporation much of the tax advantage of incorporation may be lost.

In summary, except in special circumstances, a Section 85 rollover of assets is best.

Buildings require special consideration. If the land on which the buildings are located is transferred to the corporation, then it is normally preferable to transfer the buildings as well. However, if the land on which the buildings are located is not transferred, but the intention is to transfer the buildings, then the following three alternatives exist:

- A long term leasehold agreement can be prepared which gives the corporation as the building owner the right to access the use of the buildings and a small area around them.

- The corporation could attempt to obtain a subdivision for the land on which the buildings are situated.

- The buildings are sold with the right of access and removal.

iv. Part XVII Depreciable Assets (Straight Line)

The Part XVII method of capital cost allowance applies to machinery and buildings acquired prior to January 1, 1972 by farmers which used that method.

If these assets are transferred to the corporation, they must be transferred at their fair market value. There is no recaptured capital cost allowance for Part XVII assets, however, a capital gain will occur if the fair market value exceeds the adjusted cost base (original cost or fair market value on valuation day).

v. Alternatives for Inventory

For taxation purposes, the term inventory includes all current assets that would be income when sold. Specifically, inventory will include grain, feed, livestock, and all farm supplies (fertilizer, chemicals, etc.) Grain held on a storage ticket at an elevator company is inventory. However, grain sold on a deferred cash ticket or grain delivered to an elevator with an authorization to ship is not inventory.

The following alternatives exist in handling inventory:

1. Inventory Sold Through Normal Channels – The inventory that is sold becomes income to the farmer for taxation purposes. If the farmer is in a high tax bracket, a large amount of income tax would be payable. The farmer may be eligible to forward average some or all of this income.

Implications of this option

- There may be a small amount of income tax payable if the total value of the inventory is low and the farmer is in a low tax bracket.

- The farmer may qualify to forward average.

- A large amount of income tax may be payable if the total value of this inventory is high and the farmer is in a high tax bracket.

- If forward averaging is used, extra working capital that could otherwise be available is tied up.

2. Inventory Sold to the Corporation – The inventory is sold to the corporation at its fair market value on a promissory note and it is agreed between the corporation and the transferor that the amount will be payable over time. The transferor will report the income only as payments are received from the corporation. The corporation may claim expenses only as payments on the note are made to the transferor.

Implications of this option

- Operating capital is not tied up in an off-farm source.

- Income tax is averaged for the individual over a longer term.

- Some degree of flexibility in repaying the note.

- There is no accrued tax liability to the corporation or individual.

- The individual will likely have to pay income tax over the term of the note.

3. Inventory is Rolled Over to the Corporation – Inventory can be rolled to the corporation at the lesser of cost or consideration (other than shares) received although a higher value can be elected if desired. For farms on the cash basis of accounting, the cost of inventory is deemed to be zero. Therefore, the inventory could be transferred to the corporation for $1.00 if no consideration is

received, other than shares. Preferred shares are issued to the transferor for the difference between the elected value and the fair market value of the inventory.

The transferor will not be subject to any tax on the inventory transferred. The preferred shares if redeemed or sold at market value would result in a capital gain, one half of which is taxable income. The $500,000 Capital Gains Exemption may be used to offset this amount.

The inventory transferred to the corporation will become taxable income as it is sold and the corporation will have no offsetting expense.

Implications of this option

- The corporation is placed in a strong working capital position.

- Income taxes are minimized.

- For the individual, potential taxable income (inventory) is converted to capital gain (preferred shares).

- Preferred shares may be rolled over to children thereby deferring tax for a longer period.

- Transferor receives nothing for his inventory.

- Tax liability of the preferred shares if redeemed or sold at market value, subject to the Capital Gains Exemption.

- The corporation has no offsetting expenses for the income realized when the inventory is sold.

vi. Basic Herds

A basic herd cannot be transferred to a corporation. The basic herd owner may transfer his livestock to the corporation and deduct from the proceeds the value of the basic herd animals on Valuation Day (December 31, 1971).

vii. Liabilities

Some or all of the debts of the farmer may be assumed by the corporation. Normally, the assumption of a debt is part of the consideration, other than shares received.

viii. Deemed Gifts

The full value of assets transferred to a corporation must be accounted for by way of consideration and shares. If this is not the case, the amount not accounted for may be considered a gift conferred on other shareholder of the corporation.

If a farmer sold land to a corporation that was worth $200,000, took back a note for $50,000 and 50 shares were issued to each of the husband and wife, then in effect there would be a deemed gift to the wife of one half of $150,000 or $75,000.

The deemed gift could be avoided if the husband had taken $150,000 in preferred shares in addition to the $50,000 note.

The amount of any gift conferred to other shareholders is added to the elected transfer of value of assets for the determination of capital gain.

The following example illustrates a common method of transferring assets to a corporation:

Assets	Fair Market Value	Debt	Adjusted Cost Base or Undepreciated Capital Cost	Cash or Notes	Debts Assumed	Preferred Shares	Total
Land	$600,000	$100,000	$200,000	$100,000	$100,000	$400,000	$600,000
Principal Residence (Personal Portion)	30,000	0	N/A	30,000	0	0	30,000
Part XI Assets including Business portion of Principal Residence	100,000	20,000	60,000	40,000	20,000	40,000	100,000
Part XVII Assets	10,000	0	15,000	10,000	0	0	10,000
Inventory	100,000	0	0	0	0	100,000	100,000
	$840,000	**$120,000**		**$180,000**	**$120,000**	**$540,000**	**$840,000**

In this example, there would be no tax payable by the individual for assets rolled to the corporation since the non-share consideration of $300,000 (debts assumed and cash or notes) is equal to the adjusted cost base or undepreciated capital cost allowance or tax free amount. The $540,000 of preferred shares should be retractable and redeemable. No dividend rate need be specified. If the preferred shares were sold at market value or redeemed by the corporation, the shareholder would have a capital gain of $540,000 and $270,000 would be taxable income. However, shares in a family farm corporation may be rolled over from a parent to a child. Preferred shares qualify for this rollover.

The purpose of the rollover is to allow a restructuring of the business and leave the corporation in the same relative tax position after incorporation as the proprietor was before incorporation.

In order to utilize the $500,000 Capital Gain Exemption, sufficient assets could be transferred at fair market value to generate $500,000 of capital gain. The balance of the assets could be rolled over under Section 85 of the Income Tax Act. Assets transferred at fair market value could be transferred over a five year period using an agreement for sale. This would minimize the impact of minimum tax. Alternatively, if the farmer qualified to do so, a Five Year Block Average could be applied in the year of transfer since minimum tax need not be calculated when this election is made.

V. Operation of a Corporation

The operation of an incorporated business is more complex than a sole proprietorship. Certain rules and procedures must be followed. Taxation considerations are also more complex.

1. Taxation of Corporate Income

In Saskatchewan, a corporation that qualifies as a Canadian controlled private corporation is taxed at a flat rate of approximately 25% on active business income up to $200,000 earned in one year. If taxable income exceeds $200,000, the tax rate is approximately 54%.

Most Saskatchewan farm corporations qualify for the 25% tax rate as long as the corporation is controlled by Canadians and it is not a public company.

Active business income that qualifies for the 25% rate would include earnings from farming as well as interest earned on short term deposits. Other types of investment income such as interest earned on long term investments, dividend income and capital gains are referred to as non-active business income and would be subject to the 54% tax rate. However, if these types of income were paid out as dividends a tax credit would be earned by the corporation.

The following example illustrates the corporate tax on farm earnings:

Net Farm Income (Taxable Income)	$41,200
Corporate Tax (25%)	10,300
Corporate Earnings After Tax	$30,900

2. Taxation of Dividends*

Corporations may retain their earnings after paying income tax or pay dividends to the shareholders. Retained earnings are a form of tax shelter until they are paid out as dividends.

* From 1983 to 1986, a Corporate Distribution Tax of 12.5% applied to dividends paid by a corporation out of earnings subject to the small business tax rate of 25%. Beginning in 1987 this tax no longer applies.

Any portion of a corporation's after tax earnings may be paid to the shareholders as dividends. The following example indicates a situation where all the earnings are paid out as dividends.

Corporate Earnings After Tax	$30,900
Dividends Paid	30,900
Retained Earnings	0

Shareholders who receive corporate divdends must report the dividends on their income tax return, but are able to claim a dividend tax credit. The dividend tax credit is used to prevent double taxation of earnings, since the corporation has already paid income tax on its profits.

The following example illustrates how dividends are taxed based on a cash dividend of $30,900 (see previous example).*

Cash Dividend Received	$30,900
Gross Up Dividend (33 1/3%)	+10,300
Taxable Amount of Dividend	$41,200
Personal Exemptions	−7,920
Taxable Income	$33,280
Federal Income Tax Calculation	$ 6,867
Dividend Tax Credit (16.67% of Taxable Amount of Dividend)	6,867
Basic Federal Tax	$ 0
Individual Surtax	0
Provincial Income Tax	0
Provincial Fiat Tax	$ 412
Provincial Surtax (Reduction)	(214)
Total Tax Payable	$ 198

Shareholders who receive dividends must gross up the actual cash dividend by 33 1/3% to determine the taxable amount of the dividend. The shareholder may then claim a dividend tax credit equal to 16.67% of the taxable amount of the dividend. Since the dividend tax credit reduces the Basic Federal Tax and Provincial Income Tax is calculated on the Basic Federal Tax, a dividend tax credit reduces both Federal and Provincial tax payable. The Provincial flat tax is calculated on the taxpayer's net income (taxable amount of dividend in the above example), consequently, the dividend tax credit does not reduce this tax.

The total income tax payable by the corporation and the individual in the above examples is ($10,300 + 198) = $10,498. Had the individual earned $41,200 from an unincorporated business the personal income tax on that amount would be $10,918. Routing income through a corporation then back to the individuals as dividends results in only a small savings in income tax. Tax deferral benefits occur by leaving the retained earnings in the corporation but this tax shelter is lost when dividends are paid.

* Prior to 1987, the dividend gross up was 50% of the cash dividend and the dividend tax credit was 22.67%.

3. Taxation of Non Active Business Income and Dividends Received by a Corporation

Non Active business income is taxed at approximately 54% in Saskatchewan. However, if a dividend is paid out to shareholders the corporation is entitled to a 25% Refundable Dividend Tax Credit which in effect reduces the actual rate to 29%.

Dividends received by a corporation are subject to a tax rate of 33 1/3%. However, an offsetting tax credit of 33 1/3% applies if the dividends are paid out to shareholders. This means that dividends can flow into a corporation and back out to shareholders and result in the same level of tax payable as if the shareholder had received the dividends directly.

4. Taxation of Capital Gain in A Corporation

One half of capital gain received by a corporation is taxable at a flat 54% rate. The other half is tax free. The tax free portion of the capital gain may be paid out to shareholders as a tax free dividend. The refundable dividend tax credit of 25% is available to the corporation if the taxable portion of the capital gain is paid out to the shareholders. This would result in an effective tax rate of 29%.

5. Loans to Shareholders

Taxation policy dealing with loans made by a corporation to a shareholder are very restrictive and specific.

Loans made by a corporation to a shareholder that remain unpaid at the end of the year following the year in which the loan is made will be income to the shareholder. Loans between a corporation and shareholder should be properly documented. A shareholder who receives a low interest rate loan from a corporation will be deemed to receive a taxable benefit. This occurs if the interest rate charged is less than the prescribed rate. The prescribed rate of interest is set by Revenue Canada every three months. It is based on 90 day treasury bill interest rates.

6. Taxable Benefits

Employees or shareholders who receive benefits such as personal use of a company car or house are deemed to receive a taxable benefit that must be reported by the individual as income.

7. Income Splitting

As an individual's taxable income increases, it is taxed at ever increasing rates. This is known as a progressive tax system. Because of this, lower amounts of income tax are paid by a family unit if the total income can be divided between two or more people (say a husband and wife) then if all the income was received by one person (the husband). Income splitting is a tax management technique which is used to lower the amount of income tax payable.

Prior to the 1980 taxation year a farmer was unable to claim wages paid to his spouse as an expense. Only incorporated farms were able to achieve income splitting by paying wages to both a husband and a wife. Beginning January 1, 1980 proprietorships may also pay wages to a spouse and claim the amount as an expense. The amount of wages paid to a spouse must be reasonable for the type and amount of work actually performed. Corporations and proprietorships are now in the same position with regard to the payment of wages to a spouse.

However, corporations do offer further income splitting opportunities. A spouse may purchase shares in a corporation. To the extent that dividends are paid, further income splitting is possible between a husband and wife in addition to the payment of wages. To achieve this it is important for the wife to purchase the corporations shares with her own source of money.

8. Registered Pension Plans and Registered Retirement Savings Plans

A farm corporation may set up its own registered pension plan for its employees. Employees enrolled in a company registered pension plan make make contributions to a Registered Retirement Savings Plan to a limit of the lesser of 20% of earned income or $3,500 (note that the $3,500 limit includes any contributions made to a registered pension plan). These provisions apply for 1987. New pension rules begin in 1988. Interest and dividends received by a shareholder is not earned income for the purposes of purchasing a registered retirement savings plan. Rental income, wages and salaries would be considered as earned income for these purposes.

9. Canada Pension Plan

After a farm is incorporated, the amount of Canada Pension Plan contributions will relate to the salaries and wages paid to each employee. If part of the farm continued to be operated as a proprietorship then Canada Pension contributions could also be made on those earnings. When wages are paid, the employer (corporation) makes one-half of the contributions and the employee makes the other half of the total contributions. In a proprietorship, the farmer makes the full contributions directly.

10. Deferred Profit Sharing Plans

A corporation may establish a deferred profit sharing plan for its employees. However, contributions to a deferred profit sharing plan for a shareholder-employee of the corporation is now prohibited. The value of deferred profit sharing plans for most farm corporations is very limited.

11. Tax Installments

A corporation is required to make quarterly tax installments to Revenue Canada. The installments are based on either the previous year's income tax paid or an estimate of the current year.

12. Fiscal Year

When a corporation commences operations if can select any fiscal year end that it finds most suitable. The first fiscal year need not include a full 12 month period. For example, the first year may be only seven months. Often it is desirable to end the first fiscal year just before the company begins to realize taxable income, then begin the new fiscal year. This defers the payment of tax for 12 additional months.

13. Income Tax Filing

A corporation must file an income tax return (T-2) within six months of the fiscal year end. In addition it must issue employee T-4 slips and statements of investment income (dividends and interest) paid out (T-5 slips) by the end of February each year. The corporation must include a balance sheet and profit and loss statement along with its tax return.

Individuals must file tax returns on a calendar year basis by April 30 of the following year if income tax is payable, a refund is claimed or if requested to do so by Revenue Canada.

14. Income Tax Benefits of Incorporation

Farms with high levels of net income, an objective of increasing farm size and/or with a high level of debt may achieve tax benefits by incorporating. The benefits are chiefly in the form of tax deferral rather than as tax savings. Individuals considering incorporation should calculate their tax position based on their set of circumstances to determine if benefits will occur. The following examples and tables provide a basis for these calculations.

Assumptions
- One shareholder corporation
- 1987 Tax Rates are used
- Net income is gross income less operating costs and capital cost allowance
- Net Income is assumed to be $50,000.
- Personal Exemptions
  Single $4,220
  Married $3,700
- Canada Pension Plan Contribution is 1.9% (3.8% if self employed) of pensionable earnings less $2500. Maximum contribution is $445 for an individual employed and $889 for a self employed individual when pensionable earnings exceed $25,900.

Situation A
Sole Proprietorship

Total Income	$50,000
less Canada Pension	-- 889
Net Income	49,111
less Personal Exemptions	7,920
Taxable Income	41,191
Basic Federal Tax	9,058
Federal Surtax	272
Provincial Income Tax	4,529
Provincial Flat Tax	491
Provincial Surtax	122
Total Income Tax Payable	$14,472

Situation B

Corporation - a basic wage of $26,000 is paid to the shareholder. Dividends equal to the corporate after tax income are also paid. Retained earnings are zero in all cases.

Company	
Net Income (before wages)	$50,000
Wages	−26,000
Canada Pension Plan	− 445
Corporate Taxable Income	23,555
Corporate Income Tax at 25%	− 5,889
Corporate After Tax Income	17,666
Dividend Paid	−17,666
Retained Earnings	$ 0

Individual	
Wages	$26,000
+ Cash Dividend	+17,666
+ Gross Up Amount	+ 5,889
- Employment Expense Deduction	− 500
- Canada Pension Plan	− 445
Net Income	48,610
Personal Exemptions	− 7,920
Taxable Income	40,690
Federal Income Tax	8,907
Dividend Tax Credit	− 3,926
Basic Federal Tax	4,981
Federal Surtax	149
Provincial Income Tax	2,491
Provincial Flat Tax	486
Provincial Surtax	0
Total Income Tax Payable	$8,107

Total Income Tax Payable:
$5,889 + $8,107 = $13,996

Situation C

Corporation - the objective is to maximize retained earnings in the corporation in order to obtain the greates income tax advantage. A basic wage of $26,000 is paid to maximize contributions to the Canada Pension Plan. In addition, dividends equal to 10% of the corporation's net income (before wages) are paid to the shareholder. These amounts are assumed to meet the shareholders living and income tax requirements.

Company	
Net Income (Before Wages)	$50,000
Wages	−26,000
Canada Pension Plan	− 445
Corporate Taxable Income	$23,555
Corporate Income Tax at 25%	− 5,889
Corporate After Tax Income	$17,666
Dividend Paid	− 5,000
Retained Earnings	$12,666

Individual	
Wages	$26,000
+ Cash Dividend	+ 5,000
+ Gross Up Amount	+ 1,667
- Employment Expense Deduction	− 500
- Canada Pension Plan	− 445
Net Income	$31,722
Personal Exemptions	− 7,920
Taxable Income	$23,802
Federal Income Tax	$ 4,499
Dividend Tax Credit	− 1,111
Basic Federal Tax	$ 3,388
Federal Surtax	162
Provincial Income Tax	1,694
Provincial Flat Tax	317
Provincial Surtax	0
Total Tax Payable	$ 5,561

Total Income Tax Payable:
$5,889 + $5,561 = $11,450

Total Corporate and Personal Income Tax Payable at Various Net Income Levels – One Person

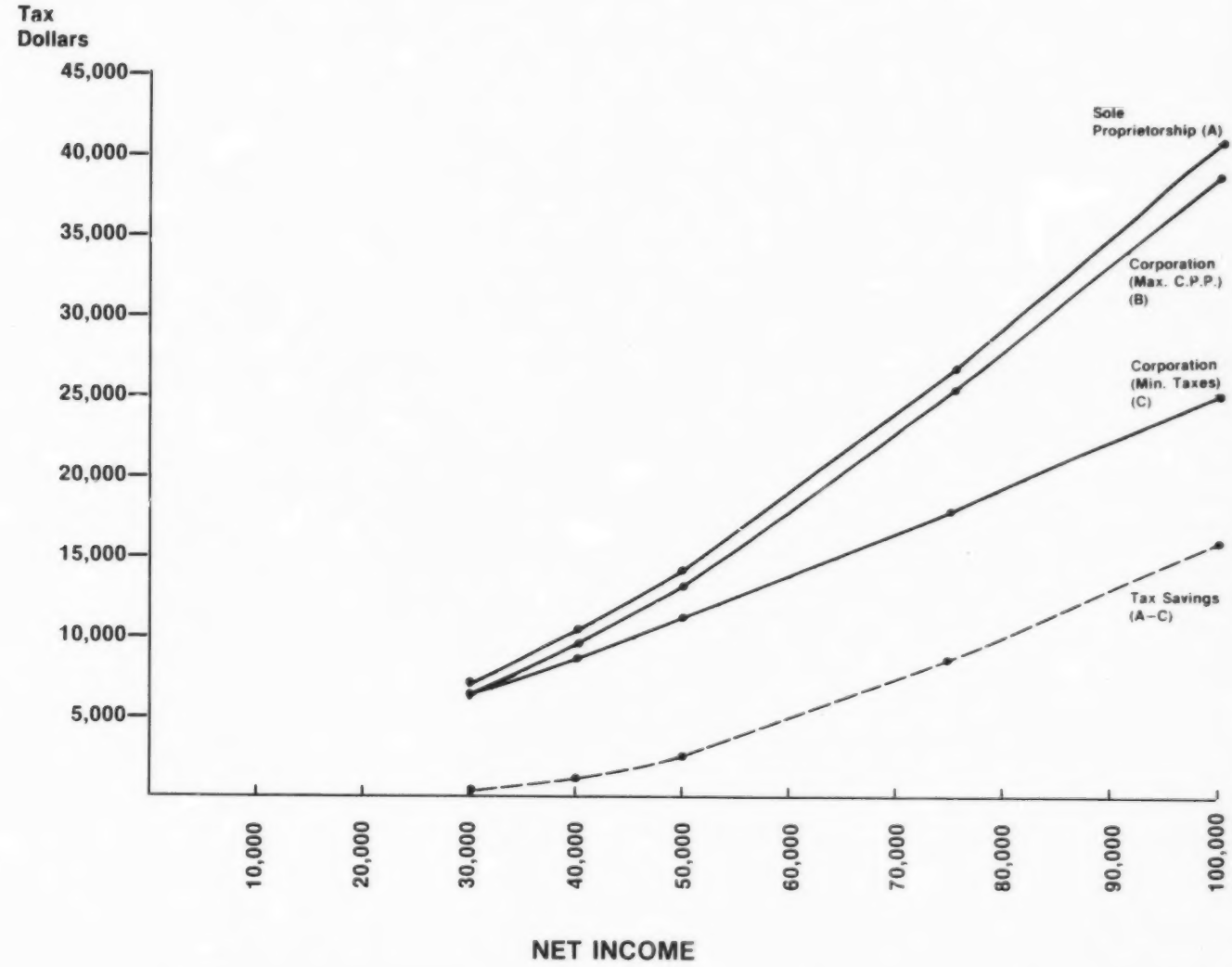
Net Income	$30,000	$40,000	$50,000	$75,000	$100,000
Situation A					
Sole Proprietorship - Tax Payable	$ 6,254	$10,100	$14,472	$26,858	$40,653
Situation B					
Corporation (Pay Dividends)					
- Wages	$26,000	$26,000	$26,000	$26,000	$26,000
- Dividend	2,666	10,166	17,666	36,416	55,166
- Retained Earnings	0	0	0	0	0
- Tax Payable	**$ 6,055**	**$ 9,837**	**$13,996**	**$25,853**	**$39,274**
Situation C					
Corporation (Max. Retained Earnings)					
- Wages	26,000	26,000	26,000	26,000	26,000
- Dividend	2,666	4,000	5,000	7,500	10,000
- Retained Earnings	0	6,166	12,666	28,916	45,166
- Tax Payable	**6,055**	**8,745**	**11,450**	**18,098**	**24,806**
Tax Difference (A compared to B)	199	263	476	1,005	1,379
Tax Difference (A compared to C)	199	1,355	3,022	8,760	15,847

A comparison of the income tax payable for levels of net income other than $50,000 is contained in the previous table and Figure 1. The assumptions and calculations are the same for the table as in the previous example.

The table illustrates that there is very little tax savings by establishing a corporation and paying the profits out as dividends (Situation B) as compared to receiving the same income as a proprietorship (Situation A). A savings of $199 occurs at the $30,000 net income level and a savings of $1,379 at the 100,000 net income level. These magnitudes of savings in relation to the net income levels are insufficient to justify incorporation.

Large tax deferral benefits occur at higher levels of net income when a corporation attempts to maximize its retained earnings (Situation C) as compared to a proprietorship (Situation A). The tax deferral is small at low levels of net income ($199 at $30,000 net income) and significant at high levels of net income ($15,847 at $100,000 net income).

Figure 1: Total Corporate and Personal Income Tax Payable at Various Net Income Levels - One Person



Further tax savings may be possible by splitting income between two or more people by paying dividends in addition to wages. It is important to remember that Revenue Canada may question excessive income splitting dividend payments particularly between a husband and wife.

Assumptions
- Husband and wife are shareholders in the corporation
- 1987 tax rates are used
- Net income is gross income less operating costs and capital cost allowance
- Net Income is assumed to be $50,000.00
- Personal Exemptions
  Basic $4,220
- Canada Pension Plan contribution is 1.9% (3.8% if self employed) of pensionable earnings less $2,500. Maximum contribution is $445 for an individual employed and $889 for a self-employed individual when pensionable earnings exceed $25,900.
- Dividends are paid out to the husband and wife on a 2/3:1/3 ratio (shares are owned on a 2/3:1/3 ratio).

Situation A

Sole Proprietorship - a wage of $10,000 is paid to the farmer's wife.

	Husband	Wife
Total Income	$40,000	$10,000
less Canada Pension Plan	-1,032*	– 143
less Employment Expenses Deduction		– 500
Net Income	38,968	9,357
less Personal Exemptions	–4,220	–4,220
Taxable Income	$34,748	$5,137
Basic Federal Tax	$ 7,235	$ 715
Federal Surtax	217	21
Provincial Income Tax	3,618	357
Provincial Flat Tax	390	94
Provincial Surtax (reduction)	1	(203)
Total Tax Payable	11,461	984

Total Income Tax Payable = $11,461 + $984 = $12,445

* Includes C.P.P. contribution for wife's wages.

Situation B

Corporation - a basic wage of $16,000 is paid to the husband and $10,000 to the wife. Dividends equal to the corporate after tax income are paid out, 2/3 of which goes to the husband and 1/3 to the wife.

Company	
Net Income (before wages)	$50,000
Wages	–26,000
Canada Pension Plan	– 400
Corporate Taxable Income	23,600
Corporate Income Tax At 25%	– 5,900
Corporate After Tax Income	17,700
Dividend Paid (Husband 2/3:Wife 1/3)	–17,700
Retained Earnings	$ 0

Individuals	Husband	Wife
Wages	$16,000	$10,000
+ Cash Dividend	+11,800	+ 5,900
+ Gross Up Amount	+ 3,933	+ 1,967
- Employment Expense Deduction	– 500	– 500
- Canada Pension Plan	– 257	– 143
Net Income	30,976	17,224
Personal Income	– 4,220	– 4,220
Taxable Income	26,756	13,004
Federal Income Tax	5,237	2,180
Dividend Tax Credit	– 2,622	– 1,311
Basic Federal Tax	2,615	869
Federal Surtax	78	26
Provincial Income Tax	1,308	435
Provincial Flat Tax	310	172
Provincial Surtax (reduction)	0	(160)
Total Tax Payable	$ 4,311	$ 1,342

Total Income Tax Payable = $5,900 + $4,311 + $1,342 = $11,553

Situation C
Corporation - the objective is to maximize retained earnings in the corporation in order to obtain the greatest income tax advantage. A basic wage of $16,000 is paid to the husband and $10,000 is paid to the wife. Dividends equal to 10% of the corporation's net income (before wages) are paid to the shareholders (2/3 to the husband and 1/3 to the wife).

Company	
Net Income(before wages)	$50,000
Wages	26,000
Canada Pension Plan	– 400
Corporate Taxable Income	23,600
Corporate Income Tax at 25%	– 5,900
Corporate After Tax Income	17,700
Dividend Paid (Husband 2/3:Wife 1/3)	– 5,000
Retained Earnings	12,700

Individuals	Husband	Wife
Wages	$16,000	$10,000
+ Cash Dividend	+ 3,333	+ 1,667
+ Gross Up Amount	+ 1,111	+ 556
- Employment Expenses Deduction	– 500	– 500
- Canada Pension Plan	– 257	– 143
Net Income	19,687	11,580
Personal Exemptions	– 4,220	– 4,220
Taxable Income	15,467	7,360
Federal Income Tax	2,672	1,114
Dividend Tax Credit	– 741	– 371
Basic Federal Tax	1,931	743
Federal Surtax	58	22
Provincial Income Tax	965	371
Provincial Flat Tax	197	116
Provincial Surtax (reduction)	0	(192)
Total Tax Payable	$ 3,151	$ 1,060

Total Income Tax Payable = $5,900 + $3,151 + $1,060 = $10,111

A comparison of the following table which shows two shareholders (husband and wife) with the previous table with a single shareholder illustrates the effect of income splitting for various net income levels.

To justify incorporation for tax reasons only would necessitate an annual tax savings in excess of $3,000.00. This level of savings is suggested because of the high initial cost of incorporating, the higher annual accounting and legal fees and because of additional administration and general red tape in a corporate structure.

Total Corporate and Personal Income Tax Payable at Various Income Levels - Husband and Wife

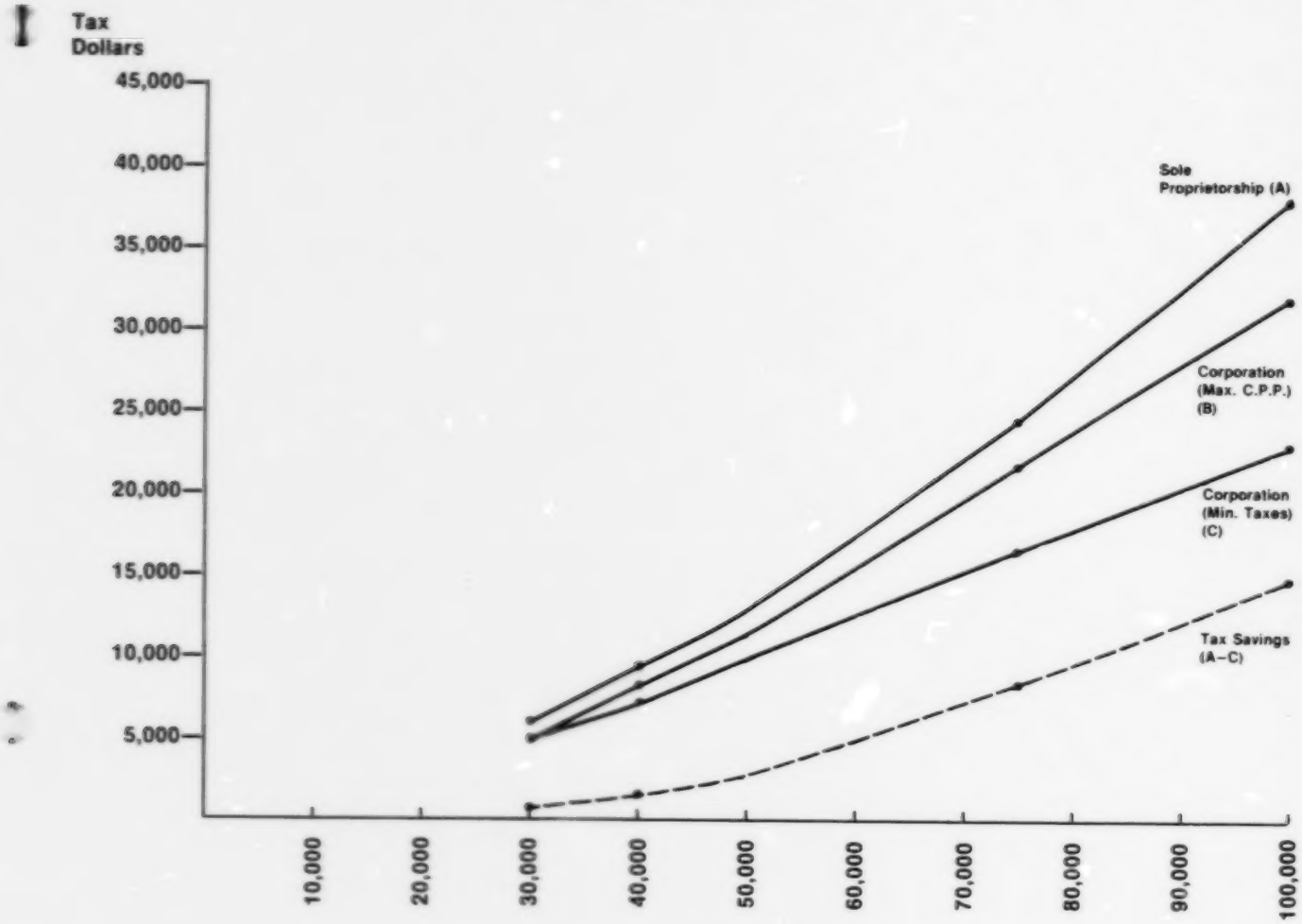
Net Income	$30,000	$40,000	$50,000	$75,000	$100,000
Situation A					
Sole Proprietorship					
- Husband Net Income	$20,000	$30,000	$40,000	$65,000	$90,000
- Wages Wife	10,000	10,000	10,000	10,000	10,000
- Tax Payable	**$5,112**	**$8,519**	**$12,445**	**$24,474**	**$38,041**
Situation B					
Corporation					
(Pay Dividends)					
- Wages - Husband	16,000	16,000	16,000	16,000	16,000
- Wages - Wife	10,000	10,000	10,000	10,000	10,000
- Dividend - Husband	1,800	6,800	11,800	24,300	36,800
- Dividend - Wife	900	3,400	5,900	12,150	18,400
- Retained Earnings	0	0	0	0	0
- Tax Payable	4,945	8,078	11,553	21,311	32,273
Situation C					
Corporation					
(Max. Retained Earnings)					
- Wages - Husband	16,000	16,000	16,000	16,000	16,000
- Wages - Wife	10,000	10,000	10,000	10,000	10,000
- Dividend - Husband	1,800	2,667	3,333	5,000	6,667
- Dividend - Wife	900	1,333	1,667	2,500	3,333
- Retained Earnings	0	6,200	12,700	28,950	45,200
- Tax Payable	**4,945**	**7,542**	**10,111**	**16,545**	**23,154**
Tax Difference (A compared to B)	167	441	892	3,163	5,768
Tax Difference (A compared to C)	167	977	2,334	7,929	14,887

It is probable that only individuals with net incomes in excess of $50,000 may achieve tax savings over $3,000 per year. However, the tax savings are really only a deferral and this can only be achieved by having the corporation build up retained earnings. In other words, shareholders must minimize withdrawals (salaries, dividends, rents, interest, etc.) from the corporation and maximize retained earnings in the corporation to achieve the greatest tax benefits. It is a form of tax shelter. The retained earnings may be reinvested in farm assets in order to achieve higher rates of growth, to pay off debt, or to purchase other assets.

Persons considering incorporation must realize that if they wish to use all the farm profits for personal reasons or at some time in the future they wish to withdraw accumulated retained earnings for personal use, that the total corporate and personal tax will be approximately equal to the tax an individual would have paid as a proprietorship.

There is a direct relationship between the amount of retained earnings and the value of the tax deferral. While it was suggested that only farmers with net incomes in excess of $50,000 should consider incorporation for tax reasons, this is only a rough rule of thumb. Each farmer considering incorporation should calculate the tax deferral benefits for his set of circumstances since variations in personal income needs, income splitting possibilities and the use of retained earnings can affect the value of a corporation for tax planning purposes.

FIGURE 2 - Total Corporate and Personal Income Tax Payable at Various Net Income Levels - Husband and Wife



In summary, farms with relatively high levels of net income and with a growth oriented objective for the farm may find incorporation advantageous. Farmers with low levels of net income and those with relatively high levels of net income but who do not plan to increase the size of their farm may find little benefit by incorporating.

15. Banking Arrangements

The financial affairs of the corporation must be kept separate from the financial affairs of the shareholders, employees, or directors. A separate bank account for the corporation is required. Severe income tax penalties may occur if corporate funds are used for personal use without proper accounting of such use.

The personal affairs of employees or shareholders should be conducted through a separate individual bank account.

16. Year End Settlements and Shareholder Advances

Advances to shareholders during the fiscal year of the corporation should be on a loan basis. On the last day of the fiscal year resolutions can be passed at a meeting which indicates how the shareholder advances during the year are to be accounted for by way of dividends, wages, interest, or repayment of shareholders' loans. Deductions from the salary must be remitted to Revenue Canada by the fifteenth day of the following month.

17. Auditor

By the unanimous consent of all shareholders, a corporation is not required to have an audit performed.

18. Decision Process

The decision process can be slower in a corporate structure than a proprietorship since certain procedures must be followed. Minutes of meetings of shareholders, officers and directors must be recorded in the minute book. Major decisions should be made at a meeting and the passing of the resolution entered into the minute book. A simple majority of the votes passed by a quorum of the shareholders will carry most decisions.

A special resolution must be passed by 2/3 of the shareholders to initiate major changes or make major decisions. A special resolution is required for such things as altering the share structure, changing the corporation's name or nature of business, restricting share transfers or changing the number of directors.

19. Annual Meeting

Ideally, an annual meeting should be held to review the past year's operation and financial statements, establish objectives for the next year, and appoint directors if required.

Rather than having a meeting, the requirements of The Saskatchewan Business Corporations Act can be met by all the shareholders signing a consent resolution for the annual meeting.

20. Annual Returns

An annual return must be filed with the Corporations Branch by the end of the month following the month of incorporation. The return must state the address of the registered office, the business in which the corporation is engaged; the date of the annual meeting, if held, the number of shares of each claim outstanding with the stated capital value and purchases or redemptions of shares by the corporation.

If there are fewer than 50 shareholders, each shareholder together with shares held of each class must be listed. In addition, the names, addresses and office held of each director must be stated.

21. Canadian Wheat Board

Under The Canadian Wheat Board Act, only actual producers of grain are permitted to apply for a Canadian Wheat Board permit book to allow delivery and sale of grain. A corporation which has grain transferred to it by a shareholder may not apply for a permit book to sell the grain. To overcome this problem, the corporation and the person who transferred the grain to the corporation can enter into a marketing agreement for the remainder of the crop year whereby the individual markets the grain on behalf of the corporation and assigns the grain cheques to the corporation.

After the corporation commences actual production, it is allowed to apply for a permit book. Only one permit book is permitted no matter how many shareholders are involved.

22. Prairie Grain Advance Payments Act

Sole proprietors are limited to a $30,000 cash advance under The Prairie Grain Advance Payment Act. Corporations with two or more shareholders may apply up to a maximum cash advance of $90,000. Additional documentation is required when a corporation applies for a cash advance.

VI. Share Transfers and Reorganization

1. Changing the Share Structure

After the corporation is established, the share structure may be altered. This requires the passing of a "special" resolution of the shareholders to permit such changes. Special resolutions require a two-third majority.

2. Issuing Additional Shares

The Saskatchewan Business Corporations Act permits the corporation to redeem shares from shareholders. Depending on the rights attached to the shares, redemption of shares may be at the option of the corporation, the shareholder or by the agreement of both parties.

Shares may be issued by the corporation until the maximum number, if any, stated in the articles of the corporation have been subscribed. Shares may be issued at such times and to such persons and for such consideration as the directors may determine. Shareholders should pay the fair market value for the shares that are issued to them. If this is not the case, the existing shareholders have their share values diluted and in effect transfer a benefit to the new shareholders.

3. Share Transfers

Shareholders may sell or transfer shares to a new shareholder subject to the bylaws or restrictions placed on the shares. Normally in a closely-held

family corporation, shares may only be transferred with the permission of all or a majority of the other shareholders or the directors.

Often shareholders will have a buy-sell agreement whereby if one shareholder wishes to sell his shares, or if a shareholder dies, the other shareholder(s) must buy the shares. In a buy-sell agreement, a term to pay off the loan and an interest rate may be specified or else the shareholder who buys the shares will be given time to raise the required capital.

Life insurance is often carried on the life of each party in a buy-sell agreement to provide liquidity to purchase the shares of a deceased person.

4. New Shareholders

In closely-held corporations, the agreement of the existing shareholders should be required to permit new shareholders to own shares. New shareholders may obtain shares from either the corporation (whereby it issues shares to the new shareholder) or by purchasing shares from existing shareholders.

When the corporation issues shares the new shareholder should pay the fair market value for the shares. The other shareholders should agree to the number of shares of the different classes to issue to the new shareholders, since this will determine the relative division among all shareholders of future growth in the corporation. It will also determine the relative voting power and division of dividends.

If the new shareholder purchases shares from existing shareholders, each existing shareholder may wish to sell a percentage of their shares in order to maintain their relative positions in the corporation.

5. Rights of Minority Shareholders to Sell Shares

Minority shareholders may find it difficult to realize on the share value if they wish to sell. In a closely-held family corporation, a non-family member is unlikely to be interested in purchasing shares. In addition, there may be restrictions on the transfer of shares.

Ideally, a shareholder's agreement or buy-sell agreement should exist to permit shareholders to realize on their share value.

6. Income Tax on Share Transfers

a. Rollover of Shares between Spouses

Shares can be transferred from one spouse to another on a capital gain rollover. The transfer may occur by way of gift during an individual's lifetime or by bequest after death. This rollover provision between spouses applies to all types of assets, not only shares. However, the income tax attribution rules apply to such transfers whereby future earnings are taxable income to the husband, not the wife.

b. Rollover of Shares to Children

Shares transferred to anyone other than a spouse are deemed to be transferred at fair market value, thereby giving rise to a capital gain. There are two exceptions to this. These are:

i. Rollover of Shares in a Family Farm Corporation

Shares in a family farm corporation and a family farm holding corporation may be rolled over from a parent to a child under certain conditions without generating a capital gain. A family farm corporation is a corporation that carries on the business of farming in Canada, uses most of its property in the business of farming and the share owner, his spouse or one of his children are actively engaged in farming. It is now generally accepted that the corporation must use at least 90% of its assets in farming to qualify. A child includes a grandchild, great-grandchild, a daughter-in-law or son-in-law, illegitimate child, legally adopted child, step child and foster child.

The rollover may occur during the share owner's lifetime or after his death. If the shares are sold to a child and the price exceeds the adjust cost base of the shares, a capital gain will occur to the extent that the selling price exceeds the adjusted cost base. If the selling price is less than the adjusted cost base, the proceeds of disposition are deemed to be equal to the adjusted cost base. If the selling price exceeds the fair market value, the proceeds of disposition are deemed to be equal to the fair market value.

The child who acquires the shares must be a Canadian resident and one of the parents, parent's spouse or any of the parent's children must be actively engaged in the farming business.

Example:

To illustrate the above, consider a father transferring shares in a family farm corporation to his son. The shares have an adjusted cost base of $50,000 and are valued at $120,000 at the time of transfer. The following table indicates the capital gain and deferral implications of various prices:

Sale Price	Father's Capital Gain	Capital Gain Deferred	Son's Adjusted Cost Base
$ 1*	$ 0	$70,000	$ 50,000
$ 25,000	$ 0	$70,000	$ 50,000
$ 50,000	$ 0	$70,000	$ 50,000
$100,000	$50,000	$20,000	$100,000
$120,000	$70,000	$ 0	$120,000

* Sale price deemed (assumed) to be $50,000.

ii. Rollover of Shares in a Small Business Corporation

Up to $200,000 of capital gain is exempt from taxation ($100,000 taxable capital gain) that would normally be realized on the transfer of shares in a small business corporation from a parent to a child. To qualify, the small business corporation must be a Canadian -controlled private corporation which uses substantially all of its assets in an active business.

Shares may be transferred during the owner's lifetime or after his death. If the shares are sold for a value in excess of the adjusted cost base, the share owner may still elect to use proceeds of disposition equal to the adjusted cost base. This provides a means for a parent to obtain a larger value for the shares without generating a capital gain. Whatever value is elected for a transfer value becomes the adjusted cost base to the child, irrespective of the price actually paid, if any, for the shares.

A corporation carrying on a farming business may qualify for this provision as well as the rollover of shares in a family farm corporation. The $200,000 Small Business Corporation rollover of shares will no longer be available after 1987.

c. Capital Gains Exemption

Shares transferred at market value are eligible for the Capital Gains Exemption.

d. Minimum Tax

Shares that are transferred at fair market value may result in a capital gain which can be offset with the Capital Gains Exemption, however, such gain may be subject to minimum tax.

7. Withdrawal of a Shareholder

Occasionally a shareholder in a corporation may wish to withdraw and establish his own separate business. It is possible for him to withdraw a portion of all the assets of the original corporation and transfer these assets to another corporation without generating a capital gain. The procedures are quite complex and would be costly for accounting and legal advice.

VII. Estate Planning

Estate planning may be simpler in a corporate structure than in a proprietorship. It is easier to transfer the business on a gradual basis by means of transferring shares, rather than land, equipment, buildings, livestock and other specific assets.

Ownership, control and the right to profit (dividends) can be separated in a corporation through the share structure. For retirement purposes it would be possible to transfer ownership yet retain the control and right to profit, for example.

Estate freezes can be accomplished in a corporation whereby a shareholder's estate can be prevented from growing in value after the corporation is established. The growth may be transferred to other shareholders by means of an appropriate share structure.

At the time of a farmer's death, his rights and things could have a high value resulting in a large income tax liability. A corporation owns these assets, therefore, when a shareholder dies, there would be a lesser tax liability for rights and things.

VIII. Dissolution of a Corporation

A corporation may be dissolved or wound up voluntarily or involuntarily. If it is wound up involuntarily, it may be as a result of being petitioned into bankruptcy under the Bankruptcy Act (Canada) or under certain provisions of The Business Corporations Act for failure to comply with certain requirements of The Business Corporations Act (Saskatchewan). The provisions for voluntary dissolution would be based on the corporation's bylaws or The Saskatchewan Business Corporations Act. The corporation would sell its assets at fair market value and, in all likelihood, receive capital gain. Income tax is payable, the debts of the corporation are paid and the balance remaining is distributed to the shareholders as dividends.

The main cost at dissolution of a farm company would be income tax payable since a large accrued capital gain normally exists on the land, recaptured capital cost allowance may occur on machinery and the value of grain and livestock becomes taxable income.

There are no tax averaging provisions available to the corporation for the above types of situations.

Legal and accounting costs will be incurred to dissolve the corporation.

A corporation can be forced into bankruptcy by its creditors under the Bankruptcy Act (Canada) or forced to dissolve pursuant to certain provisions of the Business Corporations Act. A trustee is appointed to administer the affairs of the corporation until it is wound up.

IX. Should You Incorporate the Farm?

The size of the operation, tax deferral, tax saving, income splitting, the number of individuals providing capital, labor and management, as well as their outside interests, are major factors in determining the best type of business organization.

A farm family should not dismiss incorporation simply because they do not understand its technicalities. Time, energy and some money must be invested to get the complete picture. Both the advantages and disadvantages must be considered carefully. Your objectives might be better realized through the present farm structure, a father-son operating arrangement, agreement for sale, will, etc. These should all be considered.

Most farmers should have net income consistently above $50,000 before there is likely to be a significant income tax advantage to incorporation. Where there is more than one major shareholder the net income should be a multiple of $50,000. For example $150,000 for a company with a father and two sons.

In some cases the legal benefits and family operating advantages that may occur from the corporate form of organization will make incorporation worthwhile at lower levels of net income. Situations where a farm may consider incorporation other than for income tax reasons are as follows:

1. Bringing a new person into an existing farm business arrangement.

Often a son, brother or son-in-law joins an existing farm business arrangement. The new farmer will have large debts and a high debt servicing requirement in relation to his share of the income from the total farm operation.

By incorporating, the existing members of the organization can freeze their equity at the time of entry of the new member. The corporation may acquire the assets that the new member would have otherwise acquired and spread the debt servicing requirement over a larger financial base. All shareholders will share the corporation's future growth based on the share structure determined at the time of incorporation.

2. Second Marriages

Occasionally, a man or woman with children may bring assets into a second marriage. By incorporating, each party can freeze the value of their equity at the time of marriage for the benefit of their children. The future growth in asset value and equity can then accrue to the new family unit.

3. Farmers who do not qualify for capital gain rollovers.

A bachelor with farm assets is unable to transfer any of his assets to beneficiaries on a capital gain roilover although he would qualify for the $500,000 Capital Gains Exemption. By incorporating, he could freeze his equity at that time and have the corporation issue common shares to his intended beneficiaries. The beneficiaries would receive the future growth of the corporation. At the bachelor's death, only the capital gain realized up to the time of incorporation would be taxable in the estate (subject to the Capital Gain Exemption).

It may be possible in the above situation to have the bachelor gradually reduce the capital gain liability during his life. At the time that the assets are transferred to the corporation, preferred shares with a paid up capital equal to the deferred capital gain on the assets are issued to the bachelor. Each year the corporation could redeem a portion of the preferred shares which become taxable dividend to the bachelor. Since a cash dividend of approximately $30,000 can be received by a taxpayer without paying any additional income tax, the capital gain liability on the preferred shares could be eventually eliminated.

There are many risks and considerations in using this approach. For example, if the bachelor died shortly after the corporation was established, a large deemed dividend would be taxable in his estate. Expert accounting advice should be obtained to determine the tax consequences of all alternatives and appraise the risks.

Before incorporating, discuss your plans with a friend or neighbor who is already incorporated.

If you decide to incorporate, obtain expert legal and accounting advice.

X. Information and Services Available to Farmers

1. Saskatchewan Department of Agriculture

- Provides free bulletins and counselling to the public on incorporation, income tax, estate planning, and other related areas. Bulletins are available

from Ag. Rep. offices, and other Saskatchewan Department of Agriculture offices.

- Offers courses in local farm communities.
Farm Management Section
Room 329, Walter Scott Building
Regina, Saskatchewan S4S 0B1
Phone: 787-5942

Regional Farm Management Specialists:

a. 105 Provincial Office Building
North Battleford, Saskatchewan S9A 1E9
Phone: 446-7479

b. Box 640, Main Street
Rosetown, Saskatchewan S0L 2V0
Phone: 882-4229

c. 350 Cheadie Street West
Swift Current, Saskatchewan S9H 4G3
Phone: 773-2866

d. 110 Souris Avenue
Weyburn, Saskatchewan S4H 2Z9
Phone: 842-4607

e. Provincial Building
Yorkton, Saskatchewan S3N 2Y4
Phone: 783-9743

f. Box 1480
99th Street
Tisdale, Saskatchewan S0E 1T0
Phone: 873-2693

2. Saskatchewan Department of Co-operation and Co-operative Development

- Provides free bulletins and counselling to the public on incorporation under The Co-operative Producers Association Act.

Co-operation and Co-operative Development
Credit Union Central
2055 Albert Street
Regina, Saskatchewan S4P 3V7
Phone: 787-5374

3. Revenue Canada

- Provides free booklets and information circulars on many topics.

District Taxation Offices:

a. Income Tax Building
1955 Smith Street
Regina, Saskatchewan S4P 2N9
Phone: 780-6015
Toll Free 1-800-552-8031

b. Canadian Imperial Bank of Commerce Building
201 - 21st Street East
Saskatoon, Saskatchewan S7K 0A8
Phone: 975-4595
Toll Free 1-800-772-8737

4. CCH Canadian Limited

- Sells books and pamphlets mainly
- Free publication list is available

CCH Canadian Limited
6 Garamond Court
Don Mills, Ontario M3C 1Z5
Phone: (416) 427-2992

5. International Self-Counsel Press Ltd.

- Provides booklets and information to assist individuals in handling business and legal matters themselves.

- One useful publication is "Incorporation and Business Guide for Manitoba and Saskatchewan".

- Free publication list is available
International Self-Counsel Press Ltd.
306 West 25th Street
North Vancouver, British Columbia V7N 2G1
Phone: (604) 986-3366

6. Appraisers

- Provide Valuation Day Values and current market values on a fee-for-service basis. A list of appraisers is available from the Appraisal Institute of Canada.

Appraisal Institute of Canada
507 - 177 Lombard Avenue
Winnipeg, Manitoba R3C 0W5

7. Corporations Branch

- Provides kits of forms for incorporation under The Saskatchewan Business Corporations Act. Copies of the Act are available.

Department of Consumer and Commercial Affairs
Corporations Branch
1871 Smith Street
Regina, Saskatchewan S4P 3V7
Phone: 787-2962

8. Other Information Available to Individual Farmers

a. Local Chartered Accountants and General Accountants

b. Lawyers

Appendix A

Sample Farm Corporation Financial Statements

The following example shows the financial situation prior to incorporation, the share structure and transfer of assets to the corporation and the corporation's balance sheet.

1. The Situation Prior to Incorporation

The Family: Mr. Jones, age 52; Mrs. Jones, age 50; Jack Jones -- son, age 23; Jane Jones -- daughter, age 18.

The Farm: Mr. Jones operates a two section grain farm. His son Jack recently purchased land, he also leases land and uses some of his dad's machinery.

The Plans: Mr. Jones plans to farm for several more years. He has been paying a large amount of income tax in recent years (average of $60,000 taxable income over past 4 years). Jack would like to increase the size of his farming operation. He is not paying income tax at the present time. Mr. Jones and Jack decide to establish a corporation as a means of establishing a more formalized business arrangement and also to reduce Mr. Jone's income tax.

Mr. Jones' Assets and Liabilities

	Fair Market Value	Adjusted Cost Base	
Assets			
Land 1280 acres	$ 800,000	$100,000	
House (Principal Residence) (1/4 business)	50,000	40,000	
Buildings (Part XVII)	10,000	10,000	
Buildings (Part XI)	40,000	50,000	cost
		25,000	U.C.C.*
Machinery (Part XI)	200,000	250,000	cost
		80,000	U.C.C.*
Grain and Supplies	50,000	N.A.	
	$1,250,000		
Liabilities			
Land Mortgage	$ 50,000		
Machinery	25,000		
Line of Credit	40,000		
Total	$ 115,000		
Net Worth	$1,135,000		

Jack Jones' Assets and Liabilities:

	Fair Market Value	Adjusted Cost Base	
Assets			
Land 320 acres	$224,000	$144,000	
Buildings (Part XI)	10,000	12,000	cost
		9,000	U.C.C.*
Machinery (Part XI)	20,000	25,000	cost
		16,000	U.C.C.*
Grain and Supplies	26,000	N.A.	
	$280,000		
Liabilities			
Land Mortgage	$140,000		
Machinery	15,000		
Line of Credit	10,000		
Total	$165,000		
Net Worth	$115,000		

2. Share Structure

The share structure must be developed in a manner that is consistent with the method of transferring assets to the corporation and in relation to the desired divison of future dividends and corporate growth. It was decided that Mr. and Mrs. Jones would each acquire 30% of the voting rights and also the right to future growth while Jack Jones would obtain 40% of the voting power and growth. It should be noted that the division of voting powers and growth could be different by utilizing a different share structure.

The following share structure was established:

Shares issued	Mr. Jones	Mrs. Jones	Jack Jones
100 common voting shares at $1/share	30	30	40
516,000 preferred redeemable retractable non-voting shares at $1/share	485,000	Nil	31,000

Cash is paid for the common shares from each person's own source of funds. Mr. Jones would pay $30.00, Mrs. Jones $30.00 and Jack Jones $40.00 for the common shares. The preferred shares are issued to Mr. Jones and Jack Jones as part of the consideration for the transfers of their assets to the corporation.

Transfer of Assets to the Corporation

Mr. Jones transfers all his assets except the house to the corporation and has the corporation assume his liabilities. Land is transferred at a value which generates $500,000 of capital gain in order to utilize the Capital Gains Exemption. The balance of the land value is rolled to the corporation under Section 85 of the Income Tax Act. Jack Jones transfers his assets at fair market value to utilize the Capital Gains Exemption and has the corporation assume his liabilities. Preferred shares which are retractable and redeemable are issued to avoid deemed gifts and capital gains.

Mr. Jones' Transfer to the Corporation

	Elected Transfer Amount	Preferred Shares Issued
Land	$600,000	$200,000
Building Part XVII	10,000	0
Building Part XI	25,000	15,000
Machinery Part XI	80,000	120,000
Grain and Supplies	0	150,000
Sub Total	$715,000	$485,000
Less Liabilities assumed by the Corporation	$115,000	$ 0
Shareholder's Loan	$600,000	$485,000

Mr. Jones' Net Worth after Incorporation is as follows:

House	$ 50,000
Preferred Shares	485,000
Shareholder's Loan	600,000
30 Common Shares at $1.00	30
Total	$1,135,030
Liabilities (Cash to purchase shares)	30
Net Worth	$1,135,000

Jack Jones' Transfer to the Corporation

	Elected Transfer Amount	Preferred Shares Issued
Land	$244,000	$ 0
Building Part XI	9,000	1,000
Machinery Part XI	16,000	4,000
Grain and Supplies	0	26,000
Sub Total	$249,000	$ 31,000
Less Liabilities assumed by the Corporation	$165,000	$ 0
Shareholder's Loan	$ 84,000	$ 31,000

Jack Jones' Net Worth after Incorporation is as follows:

Preferred Shares	$ 31,000
Shareholders Loan	84,000
40 Common Shares at $1.00	40
Total	$115,040
Liabilities (Cash to purchase shares)	40
Net Worth	$115,000

Mrs. Jones' Situation

Mrs. Jones purchases 30 common shares at $1.00/share from her own source of cash. As with Mr. Jones and Jack her net worth does not change as a result of incorporation.

Balance Sheet of the Corporation After Incorporation

Assets

Land 1600 acres	$1,024,000
Buildings (Part XI)	60,000
Machinery (Part XI)	220,000
Grain and Supplies	176,000
Cash (paid for common shares)	100
	$1,480,100

Liabilities

Land Mortgages	$ 190,000
Machinery	40,000
Line of Credit	50,000
Mr. Jones' Shareholder Loan	600,000
Jack Jones' Shareholder Loan	84,000
Total liabilities	$ 964,000

Owner's Equity

516,000 preferred redeemable retractable non voting shares at $1/share	$ 516,000
100 common voting shares at $1/share	100
Total Liabilities and Owners' Equity	$1,480,100

Future growth in the corporation as a result of capital gain, debt reduction or retained earnings will increase the value of the common shares. For example, if after one year the total assets are $1,600,000 and the total liabilities are $930,000 and there are 516,000 preferred shares at $1.00 per share, then the common shares have a value of $1,600,000 – 930,000 – 516,000 = $154,000. This is $154,000 ÷ 100 = 1,540 per share.

The equity ownership in common shares would then be as follows:

Mr. Jones' 30 shares x $1,540/share	= $ 46,200
Mrs. Jones' 30 shares x $1,540/share	= $ 46,200
Jack Jones' 40 shares x $1,540/share	= $ 61,600
Total	$154,000

The corporation meets the requirements of a Family Farm Corporation, therefore both Mr. and Mrs. Jones could transfer shares to their Jack or Jane at $1.00 per share on a capital gain rollover.